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Locke Lord QuickStudy: Cboe Offers to Take the SEC to the Cryptocurrency ETF Dance

WRITTEN BY

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On March 23, 2018, Cboe Global Markets, Inc. ("Cboe") sent a letter to the Securities and Exchange Commission (the "SEC"), strongly advocating for the registration of exchange-traded funds ("ETFs") that hold cryptocurrencies and digital currency futures. Cboe already pushed the envelope in late 2017 when it became the first U.S. futures exchange to offer a bitcoin futures product for trading. ***See Locke Lord QuickStudy: Back to the Future: Where Bitcoin Derivatives Are Going, We Don't Need Roads***. Cboe Futures Exchange, LLC, one of Cboe's four registered national securities exchanges in the U.S. for the trading of equity securities, was also the first national securities exchange to submit a proposal to list and trade an ETF that would hold bitcoin, and it has since submitted three additional proposals to list and trade ETFs containing bitcoin futures. Cboe Letter, p. 1.

Cboe's letter was a direct response to an SEC Staff Letter, dated January 18, 2018, that set-forth the SEC's various concerns and open questions on the viability of ETFs and cryptocurrency mutual funds. The Staff Letter was itself a reply to multiple registration statements filed on behalf of cryptocurrency investment funds and raised potential issues with:

(i) valuation
(ii) liquidity
(iii) custody
(iv) arbitrage
(v) price manipulation
(vi) fraud

concerning any cryptocurrency fund seeking to operate within the confines of the Investment Company Act of 1940. See SEC Staff Letter: Engaging on Fund Innovation and Cryptocurrency-related Holdings (January 18, 2018).

The SEC determined that "[u]ntil the questions identified [in the Staff Letter] can be addressed satisfactorily, we do not believe that it is appropriate for fund sponsors to initiate registration of funds that intend to invest substantially in cryptocurrency and related products." *Id*. This proclamation likely explains why sponsors who previously filed registration statements for bitcoin ETFs have been withdrawing their submissions in recent months.

In its March 23rd letter, Cboe addressed each issue from the Staff Letter in turn, and provided comfort to the agency that the existing regulatory structure and developing market forces provide adequate investor protections to enable a launch of a bitcoin-based fund in the near future.

Valuation

The SEC previously stated that mutual funds and ETFs must value their assets on each business day in order to strike a net asset value ("NAV"). Cboe concurred, stressing the importance of the NAV calculation and its impact on "downstream processes" such as creation, redemption, and performance tracking. Cboe Letter, p. 4. The SEC specifically pointed to the complications arising from a "forked" blockchain, which occurs when a cryptocurrency protocol is modified by its supporting community, resulting in at least two, separated chains that continue to exist in parallel. ***See Locke Lord QuickStudy: SPLITCOIN: The Impact of the World's Biggest Cryptocurrency Forking Into Two***. Cboe noted that, at least with bitcoin, most valuation issues are closely comparable to those experienced with other, more traditional assets. *Id*. It pointed to "numerous robust indices", "reliable price information available from the bitcoin futures market", and "real-time trade data available 24 hours a day from a number of different trading platforms", all of which "create reliable and robust valuation methodologies for bitcoin and potential for other cryptocurrencies." *Id*. at 4-5. And while Cboe addressed the complications arising from "forks and air drops",[1] stating that they "can easily be accommodated for with proper policies and procedures in place, as has been done with the bitcoin futures contracts", it did not shed any further light on how these complications will be addressed with future cryptocurrency valuation. *Id*. at 4.

Liquidity

Bitcoin market liquidity appears to be a particular concern for the SEC. Cboe addressed this by noting that while there are certain aspects that separate cryptocurrencies from traditional assets, "almost all of the issues related to liquidity are substantively identical to those of other commodities" and each fund should be analyzed "on a case by case basis." *Id*. at 5. Cboe's classification of cryptocurrencies as "commodities" parallels recent analyses of this technology by the Commodities Futures Trading Commission ("CFTC") and federal courts. ***See Locke Lord QuickStudy: Regulators…Mount Up! Federal District Court Formally Recognizes Cryptocurrencies as Commodities and Designates the CFTC as a Leading Fraud Regulator***. While Cboe noted that the current bitcoin futures trading volumes "may not currently be sufficient to support [cryptocurrency ETFs] seeking 100% long or short exposure to bitcoin", Cboe expects those volumes to grow comparable to other commodities, allowing the ETFs to uses bitcoin futures contracts as a reference asset. *Id*. at 5. The prevalence and growth of bitcoin exchanges was also cited as supporting liquidity demands.

Custody

Regarding custody issues, Cboe first argues that, to the extent the funds are holding cryptocurrency future contracts that are settled in cash – which are the only such cryptocurrency futures contracts currently on the market – there should be no "disparate treatment" between cryptocurrencies and other commodities supported through similar means. *Id*. at 5-6. Accordingly, "a regulated AAA credit rated clearing house should be permitted to act as custodian for a Cryptocurrency [ETF]." *Id*. at 5. For funds that contemplate holding digital currencies directly, or seek physical settlement of cryptocurrency future contracts, Cboe points to firms like Gemini Trust Company, LLC as having the capability to act as custodian for such fund assets. Cboe also took this analysis a step further, requesting that, if the SEC saw custodial standards as an important issue, it promulgate specific standards to allow the industry to build to those specifications. *Id*. at 6.

Arbitrage and Price Manipulation

For arbitrage and price manipulation, Cboe requested that cryptocurrency funds be treated in the same manner as existing ETFs holding commodities or associated futures contracts. *Id*. Based on discussions with existing bitcoin market makers and authorized participants, Cboe also believes that the spot and over-the-counter markets easily support the arbitrage mechanism for alignment of the fund with bitcoin prices. *Id*. Cboe relies on this arbitrage mechanism as providing the proper market forces to reduce price manipulation risks comparable with other commodities markets. *Id*. at 6-7. It also noted that Cboe has specifically "undertaken significant measures to detect and prevent manipulation in the bitcoin futures market" with its own cryptocurrency futures. *Id*. at 7. This includes a comprehensive surveillance sharing agreement and strict position limits. *Id*.

Fraud

While Cboe did not appear to directly address the SEC's concerns about potential fraud issues, it did raise the increased role the CFTC has taken with respect to cryptocurrencies, now viewed as commodities, which includes direct fraud regulation of cryptocurrency future contracts and indirect fraud regulation over spot and over-the-counter digital currency transactions. ***See Locke Lord QuickStudy: Regulators…Mount Up! Federal District Court Formally Recognizes Cryptocurrencies as Commodities and Designates the CFTC as a Leading Fraud Regulator***.

In sum, one of the largest players in the industry has taken up the SEC's hesitant offer to open the derivatives door to cryptocurrencies and the larger public. It is likely that, in time, that door will be opened completely.

https://www.sec.gov/divisions/investment/noaction/2018/cryptocurrency-011818.htm

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[1] An "air drop" is when a cryptocurrency platform releases new coins by creating and directly transferring them to users, as opposed to traditional currency mining.

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